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President's Page

By Harold A. Black
President, Los Angeles Bar Association

Harold A. Black

Officers and trustees of our Association are elected, serve their terms and give place to new ones. Unlike some Associations, we do not as a rule re-elect our officers. This principle of rotation in office is entirely sound. New ideas are brought out and put into practice. Some are accepted; others, after trial, are discarded. All of this makes for progress and tends to prevent "dry rot" or undue complacency. But it is our permanent staff, with its fund of experience and administrative skill that gives our Association a degree of stability and efficiency of which we may well be proud. The unobstrusive competence of our executive secretary is reflected in the work of many of our standing committees, which, aided by the helpful advice of the Association office, are performing services of great value to the bar and the public. Much of this work receives too little recognition.

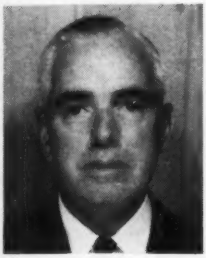
Among the most useful services done by the Association are those performed by the Committee on Arbitration. This Committee is set up by our by-laws to hear and settle disputes or differences between attorneys or between attorneys and their clients. The most usual subject of such disputes is the matter of fees. While it is

recognized that occasionally a lawyer proposes a charge that cannot be justified by the nature or quality of the services or the amount at stake in the matter at hand, much of the difficulty arises from ignorance on the part of the client concerning the extent of the work required or the expense of operating a law office. The Committee has jurisdiction to consider problems of professional conduct, of breaches of the code of ethics, but it does not attempt to arbitrate charges of serious misconduct involving disciplinary action. Cases of that sort are left to the appropriate machinery set up by the State Bar. The willingness on the part of both lawyers and clients to submit their disputes to arbitration by our Committee and the acceptance of the award when the matter is decided are gratifying and encouraging. In the 26 years that our Committees on Arbitration have been functioning, there is no record of any party seeking recourse to the courts to set aside or question an award. This indicates clearly that the members of this Committee have done and are doing their work well, and that the matters submitted to them have been carefully considered and fairly decided.

The present Committee is divided into four departments of three members each, with two alternates. Since the present Committee was organized in February 1954, five cases have been heard and decided; four other cases are pending and several other matters in all probability will be submitted for decision. No cases are heard without the agreement of both parties. All cases are heard and decided without cost to anyone. The avoidance of unpleasant and expensive litigation in these matters is an important contribution to good public relations. Chairman George W. Loring and the other members of his Committee are putting in many hours in effective and unselfish service and deserve the thanks of all of us.

The Lawyer's Role In Profit Sharing

John W. Holmes*



John W. Holmes

Congress again has demonstrated its belief that the social welfare of the nation is enhanced by greater sharing of profits between capital and labor. The trend toward employees' profit sharing, powered by tax favor under former law, should both widen and deepen in the beneficent climate of the Internal Revenue Code of 1954.

The new Code extends valuable capital gains treatment to qualified annuity plans,[1] equalizing them in this regard with other qualified plans.[2] It raises the capital gains umbrella over dependents of employees who die after retirement.[3] The new law makes easier the operation of a single profit sharing plan by affiliated enterprises by allowing profit-making members of the group to make tax deductible contributions for the benefit of their non-profitable brothers.[4] Administration of profit sharing plans is eased by giving employers more time within which to make annual contributions to profit sharing funds.[5]

In addition, the expanded concept of retirement income credit[6] and liberalized tax exemption of employees death benefits paid by a Treasury-qualified deferred compensation plan[7] will enhance the attractiveness of profit sharing.

These current developments underscore the opportunity, sometimes neglected, of lawyers to be useful to their business clients in the field of deferred compensation planning. They invite a new look at the subject of the lawyer's function in profit sharing.

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[1]I.R.C., 1954, Sec. 403(a).
[2]Ibid., Secs. 401(a), 402(a), 404(a) and (b); Internal Revenue Code of 1939, Sec. 165(b); Reg. 118, Sec. 39.165-6(a)(4).
[3]I.R.C., 1954, Secs. 402(a)(2); 403(a)(2).
[4]Ibid., Sec. 404(a)(3)(B).
[5]Ibid., Sec. 401(b).
[6]Ibid., Sec. 37.
[7]Ibid., Sec. 101(b)

THE NEED FOR LAWYERS' SERVICES IN DEVISING PROFIT SHARING PLANS

The enormous tax bite makes business managers and other knowledgeable employees attentive to ideas for salvaging a larger share of earnings for themselves and their families. When a businessman comes to realize that his employer, frequently the corporation of which he is sole or part owner, can help him accomplish this by deferring payment of part of his compensation until termination of his employment and then paying him in tax-favored dollars out of tax-deductible profits, without assuming a fixed budget obligation, he wants to know how to accomplish it.

His lawyer has an important function to fulfill at this, and every later, stage of the search for tax shelter. An adequate search involves *legal* problems affecting the estate plans of the businessman and his family, corporate procedures of his employer, selection, from the wide variety available, of a legal vehicle that will be realistic and comfortable for both employer and employees, drafting of documents to implement the plan and a working knowledge of the law, regulations and precedents controlling the subject.

Lawyers have not been uniformly receptive of opportunity to render valuable service to business clients in this field. Much of the counselling has been done by insurance men, accountants and business management advisors alert to the rewards for effective work in this area. The lawyer sometimes is merely asked to review documents drafted by someone else to activate a plan conceived and settled before the lawyer is consulted. This puts the legal advisor at a disadvantage. He is without knowledge of the possible alternatives, or the factors of estate planning, stockholder consent, employee preference, opportunities for integration of social security, pension and profit sharing benefits and other important questions that may have been discussed, resolved, or overlooked. Yet by training and experience he is perhaps better qualified than any other of the interested personnel to provide guidance in those matters where objective thinking is vital. Writers on this subject warn that any proper deferred compensation plan must be the work of a team, of whom the lawyer is an important member.[8]

Perhaps this is not so much a case of invasion from without as

[8]E.G.—Donald R. L. Franklin, 96 Jour. of Accountancy, 600, 604.

of abdication within the legal household. Busy lawyers may not welcome the necessity of time consuming self-education in order to render service in this relatively untried field of deferred compensation. Or the apparent indifference of lawyers to this opportunity simply may be reluctance to embrace the unknown, a human trait to which the profession is scarcely immune.

But there is nothing fearsome or wearisome about the subject that should repel lawyers. On the contrary, modern profit sharing challenges, by its unexploited potentialities, the lawyer's hankering for mental flight. New developments in this field, occurring almost daily, prove that the clay merely awaits the craftsman.

Workers in this new area are accorded valuable help. The new Internal Revenue Code has brought clarity and focus to the subject. Much of the hard pioneering has been done and special tools are now available. Some will be mentioned hereinafter. The local office of the Pension Trust Branch of the Internal Revenue Service is capably staffed and welcomes consultation with lawyers engaged in the tailoring of deferred compensation plans.

It is reliably reported that the rate of new filings of deferred compensation plans for Treasury approval is still increasing after years of acceleration. In the fiscal year 1952-53 the Pension Trust Branch of the Service ruled on 1,100 new profit sharing plans.[9] Since 1942, some 6,200 rulings have been made by that government agency on new profit sharing plans. It is estimated that employers have contributed in excess of $2 billion to those profit sharing plans. Approximately $1¼ billions have been contributed since August 1946.[10]

This growing migration of wealth into profit sharing plans deserves more attention than it has had from lawyers.

KINDS OF DEFERRED COMPENSATION PLANS

Deferred compensation plans have proliferated under the urgency of the tax whip. A brief and probably incomplete enumeration of basic kinds includes (1) stock option plans, (2) individual de-

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[9]The term is here used in the technical sense employed in Int. Rev. Code, 1954, Sec. 401(a) and Reg. 118, Sec. 39.165-1(2). Some 3,780 deferred compensation plans of all kinds were processed in 1952-53 by the Service (Isidore Goodman, Chief, Advisory Section, Pension Trust Branch, Internal Revenue Bureau, 4 Labor Law Jour. 804, 814, Dec. 1953). More than 24,000 Treasury-qualified profit sharing plans were in operation as of April 30, 1954 (Prentice-Hall Pension and Profit Sharing Report, June 11, 1954).

[10]Ibid.

ferred compensation contracts of various kinds,[11] (3) stock bonus plans, (4) thrift plans, (5) pension plans and (6) profit sharing plans. Combinations, variations and mutations of such basic devices are legion. Each is a study in itself. Each has advantages and disadvantages, alone and in combination with others. The present discussion is concerned primarily with a special category of the last named type, i.e.—qualified profit sharing plans within the technical meaning of the Internal Revenue Code. It aims to invite renewed attention to the opportunity of lawyers to render a useful service to the owners, part owners or key employees of businesses, large or small, who have long-term earning potential and families to protect. It is believed that the Treasury-qualified profit sharing plan affords the most likely means of meeting such a client's need for deferred compensation.

TREASURY-QUALIFIED PROFIT SHARING PLANS

An important distinction is drawn between pension plans and profit sharing plans. For present purposes, and with abbreviation, a pension plan requires annual contribution of known amount, actuarially determined, to a deferred compensation fund. Contributions to pension funds are budget items and have no necessary relation to profits. The employer contributes the actuarially determined amount each year regardless of profit or loss; hence, such plans are not generally useful to small, new or fluctuating businesses.

A Treasury-qualified profit sharing plan, on the other hand, involves contributions by the employer of a portion[12] of its *profit* to a fund held by a trustee for the exclusive benefit of employees who qualify under the plan as participants. The amount of contribution is not ascertainable until the profits are determined. The contribution is a direct function of profit. If operations result in

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[11]Some of the types of deferred compensation contracts for individual key executives include: issuance of high leverage equity stock (See: 11 N.Y. Univ. Ann. Inst. Fed. Tax'n. 161, 165); agreements to pay up to $5,000 to the beneficiaries of an employee who dies in service (excludable from gross income of the recipient under I.R.C., 1954, Sec. 101(b)(2); deductible by the employer if within limits of reasonable compensation).

[12]Neither a regular program of recurrent contributions nor a pre-determined formula for ascertaining the amount of contribution is required by law (*Lincoln Electric Co. Employees' Profit Sharing Trust v. Comm.*, 6th Cir., 1951, 190 F. (2d) 326, 40 AFTR 1018, rev. 14 T.C. 598; *Produce Reporter Co.*, 18 T.C. 69, non-acquiescence, appeal pending; *E. R. Wagner Mfg. Co.*, 18 T.C. 657). However, Reg. 118, Sec. 39.165-1(2) expressly requires such a formula. Query whether such requirement can be asserted under the new Code (I.R.C., 1954, Secs. 401(a), 404(b)). It is believed that, regardless of the courts' refusal to enforce said provision of the regulations, in most cases a formula for determining the amount of contribution stated in the written plan is a practical advantage to all concerned.

no profit, no contribution need be made. This feature assures the flexibility essential to the kind of deferred compensation plan attractive to small or new businesses or those of the "feast or famine" category.

The Treasury-qualified profit sharing plan is a legislative concept evolved during the past thirty-three years from the Congressional policy of using the taxing power of government to encourage capital to share profits with labor.[13]

The statutory pattern for tax-favored profit sharing plans, as defined in the Internal Revenue Code of 1954, is simple in outline.

Sec. 401(a) defines a qualified profit sharing trust as one created in the United States by an employer for the exclusive benefit of his employees or their beneficiaries (1) if contributions are made to the trust by the employer, his employees, or both (or by an affiliated employer, discussed infra) for distributing the fund to employees or their beneficiaries in accordance with a profit sharing plan; (2) if it is impossible, under the trust instrument, for the funds to be diverted from that purpose; (3) if the trust is designated as part of a plan intended to qualify, which benefits not less than 56% of all employees if 70% thereof, excluding seasonal and part time workers, are eligible to participate, or, lacking such number, if a classification is established that is found by the Internal Revenue Service not to discriminate in favor of officers, stockholders, supervisors or highly paid employees; and (4) if the contributions or benefits do not so discriminate in fact.

A classification is declared (5) not to be discriminatory merely because it excludes "wage earners" and is limited to salaried or clerical employees, or because contributions bear uniform relationship to compensation paid to covered employees, or because of differentials based on types of compensation other than "wages" or on retirement benefits available to covered employees under federal or state law.

No hard and fast rule of classification ever has been worked out. Each plan stands on its own feet. The indispensable requirement is that, at the outset, the Internal Revenue Service be satisfied that the plan is non-discriminatory in design and must continue

[13]For brief legislative history of modern profit sharing see 21 Geo. Wash. Law Rev. 749, 750-753.

to be satisfied from year to year that it is non-discriminatory in operation.[14]

Sec. 402(a) prescribes the method of taxing the recipients for benefits distributed by such trusts. (1) Amounts distributed before separation from employment are taxable for the year in which distributed. To the extent that the distributee-employee contributed to the trust, he recovers his contribution tax-free; benefits contributed by his employer are taxed as ordinary income. (2) But if the employee or his designated beneficiary receives all, or the unpaid balance, of his interest in one taxable year after his separation from service, or death, the proceeds are taxable as long-term capital gains insofar as they exceed the amount of the employee's contribution. Special rules apply if distribution is made in the form of employer's stock. (Rules for taxing beneficiaries of non-qualifying plans are summarized in the footnote and are to be contrasted with those above stated.[15])

Sec. 404[16] declares the deductibility from taxable income of employer contributions to a qualified trust. (a) If compensation paid to participating employees, including contributions to the trust, meets the familiar tests of reasonableness (Secs. 162, 212), an annual contribution by the employer to a qualified trust is deductible by the employer from income as a business expense to the extent of 15% of the compensation paid during the taxable year to all employees under the plan. If the employer's profits are insufficient to enable him to make the full allowable contribution in any year he may make up the deficiency in succeeding years; and if he over-pays in one year he may have the excess applied toward maximum contributions in future years (a)(3)(A). Affiliated employers, who qualify for the privilege of filing consolidated returns, may join in one or more trusts. If one or more of the employers do not enjoy enough profit in any year to make the maximum allowable contribution, the more fortunate associates may do so out of current or accumulated earnings (a)(3)(B).

If an employer, having no formal "plan", makes contributions

[14]Reg. 118, Sec. 39.165-1(4).

[15]If the trust does *not* qualify for favored tax treatment, the beneficiary is taxable on the amount contributed by the employer in the year contributed if the employee's interest is not subject to forfeiture, regardless of whether the employee receives it then or later. To the extent his interest is forfeitable he is taxed when he receives payment (Sec. 402(b).).

[16]I.R.C., 1954, Sec. 403 declares the rules for taxing beneficiaries of a qualified annuity plan; i.e., a plan qualifying in the respects stated in Sec. 401(a)(3) but providing benefits in the form of annuity contracts. The rules are substantially the same as for the non-annuity qualified trust, above summarized.

with the effect of a deferred compensation plan, he is entitled to his deduction (Sec. 404(b)).

Sec. 501 exempts from tax the income of a qualified trust, enabling the trust to pass along to the beneficiary-employees accretions realized from investment of trust funds without reduction by income taxes on such accretions. This benefit can be very substantial and is in direct proportion to income earned by the trust corpus. Of course, if the trust is a sham to conceal the true character of otherwise taxable income, or is used as a device for financing the employer's business without payment of a fair rate of interest, the exemption fails (Secs. 502, 503, 504); and qualified trusts are subject to tax on "unrelated business income" to the same extent as charitable and educational trusts (Secs. 501, 511, 512). These sensible limitations should embarrass no bona fide plan.

A qualified plan must be written, permanent in intendment and communicated to the employees.[17] Although it may be terminable at any time, the fact of termination must be reported to the Service for ruling as to tax consequences.[18] If terminated without adequate business reason or within a short time after establishment, the Commissioner might disallow all tax benefits on grounds of bad faith. This power has been sparingly used and is regarded as a means of assuring bona fides at the beginning rather than penalizing unsuccessful efforts at profit sharing.

Profit sharing plans sometimes fail; some because of termination of the business, some because of disappointment of employer or employees with the results, some because of a change to management or ownership unsympathetic to the plan. It is said that in fiscal year 1952-53, 123 rulings were issued by the Service on terminations, compared with 3,780 rulings on new plans of all kinds.[19] The Council of Profit Sharing Industries, an organization of convinced profit sharing employers, expresses the opinion that profit sharing failures are largely the result of poor management-labor relations at other levels, or of inadequate preparation of employees for reception of the plan in the first instance. Where the cooperation of employees (and their labor unions, if any) is

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[17]Reg. 118, Sec. 39.165-1(a)(1) and (3). A plan intended to last ten years apparently meets the requirement of permanence (*Lincoln Elec.* case, cited in Footnote 12, supra).
[18]Ibid., Sec. 39.165-1(a)(3).
[19]4 Labor Law Journal, 804, 814.

enlisted at the planning stage little or no employee opposition, and much support, has been experienced.[20]

The feature that makes profit sharing attractive to stockholder-employees and management personnel is the opportunity to defer receipt of part of their compensation to a future time when their tax bracket may be lower, or, because of separation from employment, the pay may be received subject to tax at the long-term capital gain rate. But this same inducement, waxing as the income tax bracket rises, leads the Service to probe for aspects of a plan that do or might discriminate in favor of the more highly paid employees. Some broad legislative restraints and some detailed administrative regulations have evolved to assure that the Congressional purpose to encourage broad sharing of profits shall not be perverted to a means of benefiting only a favored few.

First is the numerical coverage or reasonable classification requirement of Sec. 401(a)(3)(A) and (B), above summarized. Next, the legislative limit upon annual distributions is set at 15% of the compensation paid to employee participants during the year.[21] This has a dampening effect on employers bent on building up large funds for the benefit of owner-employees and managers. This limit is somewhat mitigated by the rule that if profits in one year do not permit a full 15%-of-compensation contribution the deficiency can be carried as a credit to succeeding years in which profits will permit the deficiency to be wiped out.[22] This makes for stability in the functioning of the plan.

"Vesting" provisions of the plan—that is, the feature, frequently employed, of deferring for a period of years, or on a sliding scale, the right of a participant to withdraw his full profit share if he leaves the employment, for any reason other than disability, before retirement age—must not be so onerous as to preclude lower paid employees, having a reasonable length of service, from realizing profit sharing benefits on severance of their employment.[23] The period of employment during which full vesting of employees' interests in the profit sharing fund is deferred is likely to be a point of particular scrutiny and, if unreasonable, of disapproval by the local representative of the Internal Revenue Service.

"Forfeiture" provisions, effective when the employment relation-

[20]Council of Profit Sharing Industries, "Revised Profit Sharing Manual" (1951), pp. 10-14; 27-30.
[21]I.R.C., 1954, Sec. 404(a)(3)(A).
[22]Ibid.
[23]Reg. 118, Sec. 39.165-4(a).

ship is terminated before the employee's profit share has become fully "vested", must not unduly enhance the possibility that a few employees who stay with the business a long time will receive a disproportionate amount of the profit sharing fund.[24] The Internal Revenue Service prefers to have forfeited funds applied as a credit to reduce the next employer's contribution rather than have forfeited amounts augment the profit sharing accounts of the remaining participants.

In practice, the Service's local representative who reviews the plan for qualification before its inception takes a long look at all factors that might be contributory to forbidden discrimination, including the past rate of labor turnover, the salary and bonus levels of the owner-manager-supervisory group *vis-a-vis* the rank and file, the kind and probable impact of vesting and forfeiture provisions proposed, the history of profits and nature of the business, the record of management-labor relations and anything else that provides a clue to probabilities of future functioning of the plan.

It is easy to gain the impression that the harness put on profit sharing to make it qualify for favorable tax treatment is unbearably restrictive; but this is not true where the aim is bona fide profit sharing. After the plan is qualified by letter from the Director of Internal Revenue there is no sensation of undue restraint. Unless unusual circumstances arise requiring a new review there is generally no occasion for further dealings with the Service. Appropriate data must be filed with the first year's income tax return of employer and trust, and thereafter is kept up to date.[25]

IMPORTANCE OF THE PROFIT SHARING CONCEPT TO ANY TREASURY-QUALIFIED PLAN

The foregoing emphasizes tax-saving aspects of Treasury-qualified profit sharing plans from the standpoint of the stockholder-employee or executive; but tax-saving is only one side of the coin.

Tax benefit, it may be well to recall, is the bait dangled by Congress to induce capital to share profits with labor. Lawyers possess an educated recoil mechanism from bait in any form. They will want to be convinced that tax benefits from profit sharing are not offset by economic disadvantages. They will want to know, too, whether profit sharing that may be good for another employer is good for their client.

[24] Ibid.
[25] Reg. 118, Sec. 39.165-1(c).

Advocates of profit sharing indicate that profit sharing motivated solely by tax-saving to the exclusion of belief in the profit *sharing* principle is not likely to succeed. Experience seems to demonstrate that a tongue-in-cheek attitude toward profit sharing on the part of owners or management, or the adoption of a profit sharing plan for one-sided purposes, without willingness to regard benefited employees as true partners, defeats its own purposes.[26]

But after voicing such warnings, advocates of profit sharing express great faith in it. They point out that in a world of ideological conflict "to share profits is to make every man a capitalist"[27] and that profit sharing is a potent weapon against statism and socialistic experimentation. They have gathered statistics purporting to show that under profit sharing plans, properly integrated with employee relations programs, great financial savings are realized by employers through reduction of waste, absenteeism and tardiness, lower labor turnover and increased productivity of labor.[28]

Testimonials come from an impressive variety of enterprises.[29] One prominent profit sharer, James F. Lincoln, of Lincoln Electric Company, declares:

> "Great as American industry is, it leaves largely untapped its great resource: the productive power, initiative and intelligence latent in every person.
>
> "What would happen when all want to make the wages of all workers, from sweeper to manager, a maximum? What would happen when all want to make the company profitable since it is largely owned by the workers in it?"[30]

He claims remarkable results from the practice of profit sharing:

> "(a) Lincoln workers, at least in the factory, are the highest paid employees in industry anywhere in the world.
>
> (b) Lincoln workers produce more per hour than any organization making a comparable product in the world.
>
> (c) Lincoln selling prices are less than those of any company making a comparable product. . . .
>
> (d) Lincoln stockholders have never missed a dividend since the first payment was made in 1918. . . .
>
> (f) Practically speaking there is no labor turnover.
>
> (g) There is no labor union."[31]

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[26]Footnote 20, supra, pp. 10-18.
[27]Ibid., p. 7.
[28]Ibid., pp. 5-6.
[29]Footnote 20, supra.
[30]Ibid., p. 160.
[31]Loc. cit.

All of these achievements cannot be attributed to deferred compensation profit sharing alone, as the Lincoln Electric Company espouses profit sharing in a variety of forms including, in addition to deferred compensation, a cash distribution, stock ownership and cost of living adjustment. This example illustrates the importance of the attorney's participation in thoughtful tailoring of a profit sharing plan for any specific business enterprise. The whole field should be surveyed before any special plan is adopted.

TOOLS, GUIDES AND BLUEPRINTS

Valuable reading for any lawyer contemplating work in this field will be found the brief bibliography at the end of this discussion.

It is not necessary to suggest to lawyers that each such plan, like a client's will, should reflect particular needs, desires and circumstances. However, documents embodying a profit sharing plan generally follow a well defined pattern. The American Bar Association's Committee on Pension and Profit Sharing Trusts of the Section on Real Property, Probate and Trust Law has drafted a comprehensive form of plan and trust. It is reproduced in the Prentice-Hall Pension and Profit Sharing Service (Paragraph 8301) and doubtless can be obtained from other publishers of services in this field of law. Trust officers of banks and trust companies, frequently designated as trustees under such plans, can be helpful in suggesting forms and tested clauses. Mr. Joseph B. Meier, Executive Secretary of the Council of Profit Sharing Industries, First National Tower, Akron 8, Ohio, also is cooperative in this respect. If life insurance is to be employed in the plan, much help is available from capable insurance company representatives familiar with this field. Ingenious programs, utilizing insurance, are available for integrating profit sharing with stockholder purchase-sale arrangements and for providing insurance protection for employees and their families, convertible to retirement income annuities before termination of the employment. In view of these and other available aids, the lawyer's problem is primarily one of helping his client to arrive at an intelligent selection among a myriad of possible alternatives.

A few basic points may be suggested for consideration by the legal adviser:

If the business is not well enough established to justify the

annual fixed obligation of a pension plan, the "pension" field can be eliminated at the outset and attention focussed on "profit sharing" plans.

If stock dispersal is not presently practicable, stock bonus and purchase plans can be eliminated, thus further narrowing the field; but the advantages of such plans should not lightly be rejected, for there is opportunity to combine stock purchase of bonus features with other aspects of profit sharing plans.

A decision to be made at the outset is whether employees are to be asked to contribute to the plan out of wages and salaries. If they are, cooperation of employee representatives at all stages of the planning process seems indispensable.

The extent of employee coverage by the plan is a necessary early inquiry at the planning stage. Is it to cover all, or only part of the labor force? If the latter, a red flag is raised, as qualification questions of "exclusive benefit of employees" and "discrimination" in favor of top-flight employees may be encountered.

When consideration has progressed this far, the question of a contribution formula will have arisen. How much profit can be safely and fairly earmarked for the plan? Usually this formula is expressed in terms of a percentage of profit after all expenses are met, usual reserves established and appropriate allowance made for return on invested capital.

When the skeleton of a plan has been evolved, it is helpful to discuss it with the local Internal Revenue Service representative before muscles and nerves are added. It is less painful to perform legal surgery in the early stage, before misconceptions of the plan become rooted in employer or employees.

If the selected plan involves contribution by employees of an interstate business it may be subject to the jurisdiction of the federal Securities and Exchange Commission.[32] If funds are not paid to and administered by an insurance company or administered by a regulated bank, attention should be given to the licensing provisions of the California Retirement Systems Law.[33]

Care should be exercised to avoid possible violation of constitutional or statutory rules against perpetuities.

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[32]The Securities Act of 1933, 48 Stat. 74, 15 U.S.C. Sec. 77.
[33]Cal. Corporations Code, Sec. 28,000 et seq.

LAWYERS AS BENEFICIARIES OF EMPLOYEE BENEFIT PLANS

The *Kintner* case,[34] recently affirmed by the United States Court of Appeals, Ninth Circuit, is an arresting development in the field of employee benefit planning.

It holds that a group of medical doctors doing business as a partnership in the usual manner may nevertheless gain the advantages of a tax-favored deferred compensation plan by converting their business entity into an unincorporated association, thus qualifying the entity for taxation as a corporation, and the doctor members as employees who may participate in a tax-favored employees' benefit plan. The opinion, written by Judge Leon Yankwich, who, with Judges Orr and Chambers, heard the appeal, declares that the beneficent purpose of the law should be liberally construed and that the doctors, as *"working* partners" were, in a sufficient sense of the term, "employees" within the meaning of Sec. 165 of the Internal Revenue Code (of 1939) although they may be partners under state law.

As of this writing, the decision of the Court of Appeals is not final.[35]

If the ultimate decision of the *Kintner* case favors the taxpayer, it may provide a tool—although somewhat awkward—for introducing tax-favored plans into organizations that habitually wear the partnership form, including associations of lawyers.

The problem of extending the tax incentives of employee benefit plans to professional workers is being attacked, also, on the legislative front. The so-called Jenkins-Keough Bill, inactive in the 83rd Congress, would enable self-employed workers to participate in the equivalent of tax-favored plans.[36] President Eisenhower has approved such legislation in principle and there is some indication that it may receive active attention in 1955.[37]

CONCLUSION

During the past quarter century lawyers have had to meet many novelties and interlopers within the orbit of law practice. Labor law, a modern giant, is no longer a minor sub-head under "injunctions." The law of taxation has come a long way from largely

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[34] *Kintner v. United States*, ...F(2d)......, CA, 9th, Oct. 14, 1954, affirming 107 F. Supp. 976 (U.S.D.C., Mont., 1952); P-H Pension and Profit Sharing Service, Par. 1051.

[35] The government has 90 days from entry of judgment in the Court of Appeals within which to apply to the U.S. Supreme Court for certiorari. 28 U.S.C. Sec. 2101.

[36] H.R. 10 and H.R. 11; P-H Pension and Profit Sharing Service, Par. 1026.

[37] P-H Pension and Profit Sharing Report, Vol. XV, No. 24, Par. 24.7, Oct. 15, 1954; Ibid., No. 25, Par. 25.1, Oct. 29, 1954.

academic consideration of constitutional restraints. Concern with "administrative tribunals" now is more practical, if less lofty, than analytical speculation about separation of powers that engaged the legal practitioners of twenty-five years ago. Lawyers have had to alter the content and subject matter of their practice to conform to the changing society they serve. Doubtless this process will continue, even accelerate, in an explosive era. An example is the subject of profit sharing.

The Congressionally inspired policy of encouraging wider and deeper division of profits between capital and labor has created a hybrid field in the practice of law that demands knowledge of and facility in handling a variety of traditional legal subjects, including, among others, corporations and partnerships, estates and trusts, income and estate taxes, employment and insurance contracts. The opportunity of lawyers for service in this novel field cries out to the general practitioner who frequently ignores or doesn't hear the summons. The result is that others than lawyers are tending to preempt the field. If we are right in believing that only lawyers can adequately practice law, this situation is not in the best interests of our clients.

Lawyers will render a valuable service to their clients if, in studying the new Revenue Code, they disclose for their clients the opportunities for more profitable business activity, more rewarding employer-employee relations and more effective estate planning that inhere in the use of sound profit sharing practices.

Appreciation of the Los Angeles Bar Association is extended to the members of the Federal Courts Criminal Indigent Defense Committee who are contributing their services and time on behalf of the Association and the Bar in general. Those who volunteered to serve during the month of November, 1954, are as follows:

RALPH R. BENSON	THOMAS H. GREENWALD
GEORGE BOSHAE	MARTHA JEFFERSON
RICHARD R. CODY	HERBERT NASHBAUM
HAROLD DROOZ	JOSEPH RABIN
JACK DUNAWAY	WILLIAM D. SPECTOR
ALBERT J. FEDERMAN	CHARLES TAYLOR

PETER T. RICE, *November Committee Chairman*

1954 Revenue Code — Partnerships

This is a continuation of the review of the 1954 Internal Revenue Code prepared by the Committee on Taxation, Los Angeles Bar Association. Previous articles were presented in the November issue of the BAR BULLETIN.

In general. The new Code retains the former scheme of regarding the partnership as merely an income-reporting and not a taxable entity, but differs from the prior Code in that it establishes a complete statutory pattern for the tax treatment of contributions to a partnership, distributions by a partnership, transfers of partnership interests by sale or upon the death of a partner, termination of partnership taxable years, transactions between partners and the partnership, and payments to a retired partner or a deceased partner's estate or heir. Greater emphasis is now placed on the provisions of the partnership agreement as controlling the tax consequences. Present partnership agreements should therefore be reviewed, and future partnership agreements drawn, with a full awareness of the tax consequences resulting from the choice (or absence) of provision therein.

Effective dates. The new provisions generally apply only to a partnership's taxable years beginning after December 31, 1954, and to any partner's taxable year falling within such partnership's taxable years. Sec. 771(a). Certain "loophole closing" provisions are made effective at earlier dates: March 9, 1954, for provisions aimed at collapsible partnerships (Sec. 771(b)(2) and (3)); April 1, 1954, for provisions relating to adoption or change of taxable year of partnerships (Sec. 771(b)(1)); and December 31, 1954 (date of death), for provisions relating to income in respect of a decedent (Sec. 771(b)(4)). Also, an election is granted to partnerships to use certain of the new code provisions in the case of a partnership's taxable year beginning after December 31, 1953, and before January 1, 1955. Sec. 771(c).

What is a partnership. As under prior law, the definition of a partnership for tax purposes is broader than under local law. Secs. 761, 7701(a)(2). Regulations are authorized to allow an *election* to certain unincorporated organizations *(e. g.,* co-tenancies) to be excluded from the provisions of the subchapter relating to partnerships (*i. e.,* to be treated as individuals). Sec. 761(a). Conversely, in certain circumstances an unincorporated business may elect to be taxed as a domestic corporation. Sec.

1361. The provisions of prior law in regard to "family partnerships" are substantially retained. Sec. 704(e).

Income (distributive shares) of partners. As under prior law, the partnership acts as a mere conduit as to income and loss items, transferring them directly to the individual partners, who are taxable on their distributive shares of partnership income. Secs. 701, 702. In general, each partner's distributive share of partnership income, deductions, or credits will be determined in accordance with the partnership agreement. Sec. 704(a). And, in order to make it possible for the partners to provide for an equitable allocation of income or other items with respect to property contributed to a partnership at a valuation different from its adjusted basis in the hands of the contributing partner, the Code expressly authorizes the partners, by the partnership agreement, to provide for the distributive shares to be determined in a manner which takes into account the difference between the adjusted basis and the fair market value of contributed property at the time of contribution. Sec. 704(c)(2). In the absence of any provision in the agreement on this point, the allocation of such income and other items would be made under the general profit or loss ratios stated in the agreement. Such general ratios, however, may not produce the desired tax result at all.

Determination of basis of partner's interest. In general, the unadjusted basis of a partner for his interest in the partnership is his basis for any contributions to the partnership and the amount he paid for any purchased interest. Sec. 705(a). However, the Secretary is empowered to adopt regulations under which the partner's adjusted basis for his interest in the partnership may be determined by reference to his proportionate share of the adjusted basis of partnership *property* upon a termination of the partnership. Sec. 705(b). This alternative method may be useful when the general method becomes too complex because of the required adjustments to basis.

Taxable years of partners and partnership. Under the new Code (Sec. 706) there is less freedom of choice of the taxable year for the partnership than under the prior law. An existing partnership with a fiscal year different from the taxable year of its partners can continue this arrangement. But a new partnership cannot establish, nor can an existing partnership change to, a taxable year different from that of its "principal'" partners. Sec. 706(b).

Termination of a partnership ends its taxable year as to all partners. Sale of an entire partnership interest or the complete retirement of a partner closes the partnership tax years as to the selling (or retiring) partner only. Sec. 706(c)(2); and see Conf. Rep. thereon. Death of a partner does not close the tax year as to the partnership, but *may* close the tax year as to the deceased partner *if the partnership agreement so provides.* Sec. 706(c). The statutory definition of "termination" of a partnership may result in closing the partnership tax year when this is not intended, unless care is exercised. Sec. 708(b).

Contributions of Property to the Partnership

There are three tax problems arising in connection with contributions of property other than money to a partnership. They are:

1. Recognition of gain or loss to the contributor where the property is transferred to the partnership at an agreed valuation differing from the contributor's tax basis.
2. The partnership's tax basis of the contributed property and the contributor's tax basis of his interest in the partnership.
3. Allocation among the partners of the depreciation, depletion, or gain or loss with respect to the contributed property.

With respect to recognition of gain or loss on the contribution, Sec. 721 makes it clear that neither gain nor loss is recognized to the contributor, to the partnership, or to the other partners.

The answers to the basis problems are in accordance with normal tax concepts pertaining to non-taxable exchanges. The partner who contributes property other than money obtains a basis for his partnership interest equal to his tax basis of such property. Sec. 722. The partnership's tax basis of the contributed property is the adjusted basis of that property in the hands of the contributor. Sec. 723.

More difficult problems are encountered with respect to the allocation of depreciation, depletion, or gain or loss with respect to the contributed property. In the absence of a special provision in the partnership agreement, depreciation, depletion, or gain or loss with respect to contributed property is allocated to the partners in the same manner as though the property were purchased by the partnership. Sec. 704(c)(1). Thus, if property with a tax basis to the contributor of $3,000 is contributed to the partnership at an agreed valuation of $5,000 and later the property is sold by the

partnership for $5,000, the partnership has a taxable gain of $2,000. This $2,000 gain is allocated to the partners in the ratios of their interests in profits and losses as specified in the partnership agreement. Since the property is sold at the same price at which it was contributed to the partnership, there is no economic gain to the partnership or to the other partners. Nevertheless, under the general rule the other partners are charged with tax on their allocable portions of the $2,000 taxable gain.

If the partners do not wish to be governed by the general rule, they may have a special provision in the partnership agreement under which there is allocated to the contributor the tax consequences of his adjusted basis of the contributed property being different than the agreed value at which the property came into the partnership. Sec. 704(c)(2).

Special rules are also provided under Sec. 704(c)(3) with respect to the contribution of undivided interests in property. The effect of Sec. 704(c)(3) is to make each partner responsible for the tax consequences of the basis of his undivided interest in the contributed property. This provision is designed to eliminate the necessity for fine-line distinctions between a joint ownership of income-producing property and a partnership operation.

The provisions of the 1954 Code discussed above become generally effective for any partnership taxable year beginning after December 31, 1954. Sec. 771(a). However, it should be noted that in spite of this postponement of the general effective date, property which was contributed to a partnership in prior years at an agreed value which was different from its tax basis to the contributor will be affected by the provisions of Sec. 704(c) governing allocation of depreciation, depletion, and gain or loss in later partnership taxable years which are subject to the 1954 Code. For this reason, it may be desirable in some situations to revise existing partnership agreements to take advantage of the provisions of Sec. 704(c).

Distributions of Property by the Partnership

Special problems are encountered in connection with distributions if the partnership has among its assets unrealized receivables or appreciated inventory as defined in Sec. 751. In this portion of the article, it is assumed that the partnership has neither unrealized receivables nor appreciated inventory.

Different rules are established with respect to a distribution that is in liquidation of the entire interest of one or more partners

(referred to herein as a complete liquidation distribution) and all other distributions (referred to herein as current distributions).

The first tax problem involves the recognition of gain or loss on the distribution. Neither the continuing partnership nor the other partners have any gain or loss. Sec. 731(c). This leaves only the distributee to consider.

In connection with either a complete liquidation distribution or a current distribution, the distributee has taxable gain to the extent of the excess of the money received over the adjusted basis of his partnership interest. Sec. 731(a)(1). If the distribution is in the complete retirement of a partner's interest, and if only cash is distributed to the partner, loss will be recognized to the extent of the excess of the distributee's basis of his partnership interest over the cash received. The distributee never has a deductible loss for income tax purposes if he receives property other than money. The deduction of his loss is postponed until he disposes of the property received. In the case of a current distribution, no deductible loss is recognized.

As in the case of contributions of property to the partnership, the more difficult problems concern basis of property. If the distribution is in complete liquidation of the distributee's interest in the partnership, the tax basis of his partnership interest is allocated to the distributed property. Sec. 732(b). If more than one property is distributed, the allocation is made in the proportions of the adjusted bases of the distributed properties in the hands of the partnership immediately prior to the distribution. Sec. 732(c)(2).

In the case of a current distribution, the general rule is that the partnership's tax basis of the distributed property carries over into the hands of the distributee. Sec. 732(a)(1). If, however, the distributee's basis of his partnership interest is less than the partnership's basis of the distributed property, then the tax basis of the distributed property in the hands of the distributee is limited to his basis of his partnership interest. Sec. 732(a)(2). This is the same rule that is applied in the case of a distribution in complete liquidation of a partner's interest.

The distributee partner's basis of his partnership interest is reduced by the amount of cash distributed to him and by the basis in his hands of the partnership property other than money dis-

tributed to him. The partner's basis of his partnership interest can never be reduced below zero. Sec. 733.

As a matter of fairness to the continuing partners, it is necessary to make provision for an adjustment to the tax basis of undistributed partnership property following either a current distribution or a complete liquidation distribution. Such an adjustment is made where the distributee partner has taxable gain or loss on the distribution, or where the distributed property takes a basis in the distributee's hands which differs from the basis of that property in the hands of the partnership prior to the distribution. Sec. 734. The purpose of the adjustment is to maintain a proper relationship between the partnership's tax basis of its undistributed property and the total of the partners' bases of their partnership interests. The adjustment to the basis of the undistributed partnership property cannot be made unless the partnership has filed the election described in Sec. 754.

Payments to a Retiring Partner or to a Deceased Partner's Successor in Interest

Not infrequently the partnership agreement will provide for payments to a retiring or deceased partner in excess of his interest in the tangible properties of the partnership. These payments may be for his interest in good will, or they may be a form of mutual insurance among the partners.

Sec. 736 undertakes to establish specific rules which will determine whether the payment to a retiring or deceased partner is for his interest in the partnership property, or for his continuing participation in partnership profits. Payments for his interest in the partnership property are treated for income tax purposes under the rules applying to distributions of property as discussed above. Under Sec. 736(b)(2), payments for the retiring or deceased partner's interest in partnership property should not include amounts paid for:

1. Unrealized receivables of the partnership, as defined in Sec. 751, or for
2. Good will of the partnership, "except to the extent that the partnership agreement provides for a payment with respect to good will." The Senate Finance Committee Report states that the value attributed to good will must be reasonable.

All payments to a retiring or deceased partner, other than for his interest in the partnership property, constitute ordinary income

to the recipient and reduce the partnership income taxable to the continuing partners. This is true whether such payments are based upon partnership income or are payments of specified amounts of money.

Sec. 736 is of great importance in tax planning relative to the retirement or death of a partner. If the partnership agreement is properly drafted the partners have a substantial control of the tax incidents of the payments to the retiring or deceased partner. If it is desired that these payments constitute a capital transaction, the partnership agreement should specify that the payments are for the retiring or deceased partner's interest in good will. On the other hand, if it is desired to make the payments a distribution of partnership income and thereby reduce the taxable income of the other partners, all that is required is to omit in the partnership agreement any provision for payment for an interest in good will.

As in the case of contributions of property to a partnership, the general effective date of the distribution provisions is for partnership taxable years beginning after December 31, 1954. Sec. 771(a). However, the partnership has an option, in the case of distributions made during partnership taxable years beginning in the calendar

year 1954, to elect to have certain provisions of the 1954 Code apply to such distributions. Sec. 771(c).

Transfers of interests in partnerships. The sale of a partnership interest will generally result in capital gain or loss. Sec. 741. However, if the partnership had any "unrealized receivables" or "inventory items which have substantially appreciated" (which terms are defined in the Code), a portion of the gain or loss will be treated as ordinary income or loss. Sec. 741, 751. This is aimed at the "collapsible partnership" device. (See also Secs. 713(c), 735 and 751, *re* ordinary income from *distributed* receivables and inventory items.)

The transferee's basis for the transferred partnership interest is generally his cost (if the interest is purchased), or the fair market value at the valuation date for estate tax purposes (if the interest is acquired upon the death of a partner). Sec. 742. Although there is thus an "upped" basis for the *interest,* the transfer does *not* generally result in any adjustment to the basis of the partnership *properties.* Sec. 743(a). However, an *election* is granted (Secs. 743 and 754) to the partnership to adjust its basis for its properties, for the benefit of the transferee partner only, to reflect his

Issue Editor—Robert G. Taylor

upped basis for his interest. (Sec. 743(b); and see Conf. Rep. thereon. Since it may be that neither the transferor nor the transferee partner would be in a position at the time of the transfer to compel the partnership to make this election, and since the other partners may at that time resist making the election because of the accounting problems involved, consideration should be given, at the time of drafting the partnership agreement (or, with respect to existing agreements, at the time of reviewing them in the light of the new provisions), to whether the agreement should contain an express provision as to the rights of any transferor or transferee partner in this regard. (See, however, Sec. 732(d) for some degree of amelioration of the detriment to the transferee partner from the failure to make the election under Secs. 743 and 754.) Note also the similar election granted (Secs. 734 and 754) to the partnership to adjust the basis of its *retained* property following certain distributions to partners. See Sec. 734(b).

Special rules are provided for the allocation of basis among the partnership properties when the election is made under either of the above sections (Secs. 743 or 734, and 754) to adjust the basis of partnership properties. Secs. 734(c), 743(c), and 755.

An article on Estate and Gift Tax implications of the 1954 Revenue Code will appear in a subsequent issue.

Brothers-In-Law

By George Harnagel, Jr.

George Harnagel, Jr.

The Brief Case, monthly publication of the Bar Association of **San Francisco,** has taken on a new and very engaging look. In fact it is now one of the most attractive association publications that we are privileged to receive.

As to content, bar association publications range from those which confine themselves largely to scholarly articles on legal subjects to those which are devoted largely to reporting news of lawyers and lawyers' group activities, with a great many in between which combine these elements in varying proportions. *The Brief Case* is way out on the newsy end of the spectrum.

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The Committee on Unauthorized Practice of the **Iowa** State Bar Association has secured a decree enjoining the Carleton D. Beh Company of Des Moines, an investment banking firm, from designating in municipal bond contracts the names of counsel to be employed by municipalities in bond issue proceedings.

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The **Colorado** Bar Association is distributing to the public a pamphlet entitled "Don't Sign on the Dotted Line . . . Until."

* * *

The **Washington** State Bar Association joins the list of state associations which either have acquired, or are actively planning to acquire, their own headquarters building.

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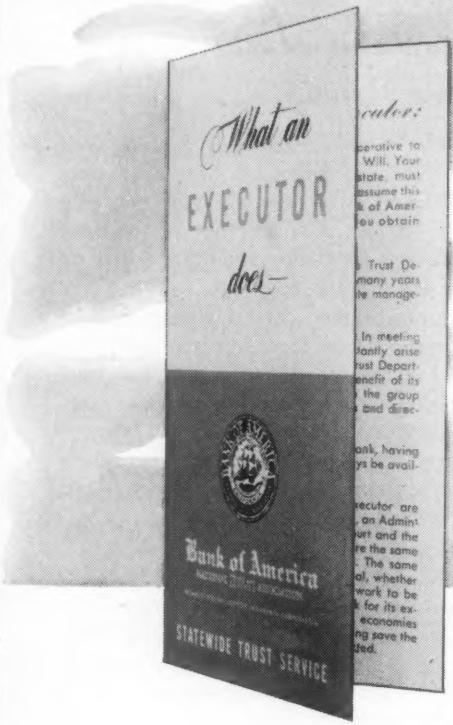
Although we have long been accustomed to alphabetical agencies and organizations, we did look twice when this one swept across our line of vision: COCLEOALICWABA. We will dedicate our next demurrer to the first reader who comes up with the correct translation. And we will go so far as to drop the hint that COCLEOALICWABA is devoted to the best interests of the legal profession.

Choosing the right Executor is as important as consulting an Attorney when making a Will.



This pamphlet will help YOU help your client...

Our pamphlet, "What an Executor does," explains in detail the kind of service our bank can make available to your client as *Executor of his Will.* If you would like copies, simply write our Trust Department... or ask for them at any Bank of America branch.

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"For some years, there has been an apparent inclination among large bar associations to relax and have fun on hitherto sacrosanct occasions. [Our association] and some other associations have dipped dignified and somewhat hesitant tootsies into the mainstream of jollification at times in the past. But this time [we] took the whole plunge and came up grinning broadly. In fact, the building seemed to shake with 'innocent merriment' when a broad burlesque, called *Res Ipsa Loquitur,* came to a close with six somewhat portly visitors from the Queens Bar Association horning into a simulated Court of Appeals with one of the choicest can-cans ever seen in Fourteenth Street, the Moulin Rouge or Vesey Street. . . ." —*The Bar Bulletin* of the **New York County** Lawyers Association.

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The Central Purchasing Committee of the **Iowa** State Bar Association has entered into a contract with an office supplies company under which members of the association will be able to purchase office supplies, stationery and equipment at discounts running as high as 26%.